No. 06-480

IN THE

Supreme Court of the United States

LEEGIN CREATIVE LEATHER PRODUCTS, INC.,

Petitioner,

v.

PSKS, INC.,

Respondent.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR WILLIAM S. COMANOR AND FREDERIC M. SCHERER AS *AMICI CURIAE* SUPPORTING NEITHER PARTY

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STATEMENT OF INTEREST OF *AMICI CURIAE*[1]

Amici are two economists who have been writing and teaching in the field of industrial organization since the mid-1960s. Both served as Directors of the Bureau of Economics at the Federal Trade Commission and both are former presidents of the Industrial Organization Society. Both have written extensively about the economics of resale price maintenance (RPM) and vertical restraints more generally.

William S. Comanor is Professor of Economics at the University of California, Santa Barbara, and Professor of Health Services at the University of California, Los Angeles. He also served as Special Assistant to the U.S. Assistant Attorney General for Antitrust in 1967 and 1968. Frederic M. Scherer is Aetna Professor of Public Policy Emeritus at the John F. Kennedy School of Government, Harvard University. Neither *amicus* has had any employment or consulting relationship with the parties to this litigation, although work by *amicus* Scherer was cited in briefs to the Court by counsel for both petitioner Leegin and respondent PSKS.

Amici submit this brief in part to set the record straight on Scherer's views, but also to provide insights on the economic literature concerning resale price maintenance (RPM) and to suggest a tractable approach for implementing antitrust standards on RPM.

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[1] Counsel for both parties have consented to the filing of this brief, and their consents have been filed with the Clerk of this Court. No counsel for either party had any role in authoring this brief, and no person other than the named *amici* and their counsel has made any monetary contribution to the preparation and submission of this brief.

SUMMARY OF ARGUMENT

The assertion that output-expanding resale price maintenance enhances consumer welfare, often cited as a defense of RPM, should be recognized as a special case not applicable under plausible conditions. The free-rider justification for RPM is also not universally applicable and should be subjected to critical scrutiny, as the Federal Trade Commission did in *In the Matter of Toys "R" Us*, 126 F.T.C. 415, 567-607 (1998). To the extent that the economic literature provides support for resale price maintenance as welfare-enhancing, the support is limited to cases of manufacturer-induced RPM, not retailer-induced RPM. The distinction should be recognized in adjudicating RPM complaints. Retailer-induced RPM should give rise to a rebuttable *per se* approach, whereas manufacturer-induced RPM should be subjected to a rule of reason when it is widespread within a product line or effected in concentrated oligopolistic markets.

ARGUMENT

A. The Conflicting Citations

In its *certiorari* brief filed before the Court on November 6, 2006 at page 16, respondent PSKS cites work by *amicus* Scherer to support the position that "the elimination of resale price maintenance has led to significant savings for consumers." In its reply brief filed on November 20, 2006 at pages 6-7, petitioner Leegin quotes a statement by *amicus* Scherer from the cited work that "[m]y own view has long been that vertical restraints are benign or efficiency enhancing more often than not, leading me to recommend that a rule of reason be applied." It goes on to observe that *amicus* Scherer

was among the 25 economists submitting an *amicus curiae* brief urging that the *per se* rule against resale price maintenance be overturned.

There is no necessary conflict here. It is entirely possible for resale price maintenance arrangements to be efficiency enhancing in some circumstances but injurious to consumer welfare in others. And given this diversity of effects, one could reasonably take the position that a *rule of reason* rather than a *per se* approach is warranted. What does need clarification, however, is that *amicus* Scherer agreed to sign the 25 economists' brief only on the condition that the cited article by Scherer summarizing research on the consumer harm from RPM, along with one by *amicus* Comanor, be referenced in the section acknowledging that there is "disagreement within the economics literature, and among *amici*, regarding the frequency with which minimum RPM has pro-competitive or anticompetitive effects." [Section I.C.4 of the 25 economists' brief.]

The 25 economists' *certiorari* brief urges that the long-standing *per se* rule against resale price maintenance be replaced by a *rule of reason*, but offers no suggestion how the rule of reason would be implemented. If the Court accepts that plea, it is essential that the Court articulate guidelines for implementation by the lower courts. A primary purpose of this brief is to suggest such guidelines. *Amici* believe strongly that a rule allowing all RPM, good and bad, to proliferate would impose significant burdens on the U.S. economy. That lesson was clearly recognized when Congress repealed the Miller-Tydings Act in 1975. It should not be forgotten.

B. Theoretical Foundations

Before making policy suggestions, we need to clarify certain points that are both theoretical and empirical. It is uniformly acknowledged that RPM and other vertical restraints lead to higher consumer prices.[2] And studies have suggested that these higher prices can be substantial.[3] According to an argument originally advanced by Robert Bork, however, the higher RPM-induced retailer margins lead to increased pre-sale services by retailers, which in turn causes output to expand. As a result, the higher margins promote enhanced consumer welfare and efficiency.[4]

Although Bork's point is sometimes correct, it is not always so. *Amici* Comanor and Scherer have both shown that consumer welfare can decline even though output is increased.[5] The net welfare consequence depends critically

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[2] As long ago as 1984, Judge Frank Easterbrook wrote: "Every argument about restricted dealing implies that the restrictions influence price. There is no such thing as a free lunch; the manufacturer can't get the dealer to do more without increasing the dealer's margin." Frank H. Easterbrook, *Vertical Arrangements and the Rule of Reason*, 53 Antitrust L.J. 156 (1984).

[3] F.M. Scherer and David Ross, *Industrial Market Structure and Economic Performance*, 3rd ed. (1990) at pp. 555-556.

[4] Robert H. Bork, *The Antitrust Paradox* (1978), p. 290; and *Resale Price Maintenance and Consumer Welfare*, 77 Yale L.J. 950 (1968).

[5] The most transparent synthesis of two earlier proofs is found in Scherer and Ross, *supra* note 2 at pp. 541-548. It extends and simplifies F.M. Scherer, *The Economics of Vertical Restraints*, 52 Antitrust L.J. 687 (1983); and William S. Comanor, *Vertical Price Fixing and Market Restrictions and the New Antitrust Policy*, 98 Harv. L. Rev. 990 (1985).

upon the nature of the demand shift induced by the provision of pre-sale services as well as the magnitude of the shift (*i.e.*, the elasticity of demand with respect to the volume of pre-sale services).

The intuition for this result follows from the likelihood that consumers who derive substantial consumer surplus from a product are likely to be informed of the product's merits without any special help from retailers. These infra-marginal consumers are harmed by the higher prices resulting from RPM. On the other hand, it is the less informed, marginal consumers who derive most of the benefits from the services and whose purchases increase. This is a plausible situation, as it is recognized that the consumers most likely to be influenced by additional pre-sale services are those "who are indifferent between purchasing or not."[6] Furthermore, to the best of *amici*'s knowledge, no one has rebutted their proof that the Bork result is a special case not applicable under many circumstances. The Bork argument should not be accepted by the Court as a general principle.

A second point concerns the most popular defense for supplier-mandated RPM, which is the so-called free-rider argument.[7] It asserts that unless all distributors are required to charge the same high price, a high-price retailer may provide pre-sale services, after which a customer who has received those services without charge will purchase the item from a "free-riding" distributor who provides no such

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[6] James Cooper, Luke Froeb, Daniel O'Brien, and Michael Vita, *Vertical Restrictions and Antitrust Policy: What About the Evidence?* 1 Competition Pol'y Int'l 45, 49, 51 (2005).

[7] This argument was made originally by Lester Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & Econ. 86 (1960).

services but sets a lower price. RPM is needed to prevent free-riding and ensure that desired services are supplied.

Although this result is possible, there is skepticism in the economic literature about how often it actually occurs.[8] In the most thoroughly litigated antitrust case known to *amici*, Toys "R" Us argued that a different type of vertical restraint — a boycott of warehouse clubs TRU coerced from toy manufacturers — was justified because the warehouse clubs free-rode on TRU's inventory stocking and advertising activities. The Federal Trade Commission found TRU's free-rider defense to be without merit,[9] and on appeal, the Seventh Circuit agreed:[10]

> Here, the evidence shows that the free-riding story is inverted. The manufacturers wanted a business strategy under which they distributed their toys to as many different kinds of outlets as would accept them: exclusive toy shops, TRU, discount department stores, and warehouse clubs. . . . What TRU wanted or did not want is neither here nor there for purposes of the free rider argument. . . .

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[8] The literature is reviewed in Scherer and Ross, *supra* n. 4, at pp. 551-555. *See also* William S. Comanor, *The Two Economics of Vertical Restraints*, 5 Rev. Indus. Org. (Summer 1990), and William S. Comanor, F.M. Scherer and Robert L. Steiner, *Vertical Antitrust Policy: Getting the Balance Right*, American Antitrust Institute, September 6, 2005.

[9] *In the Matter of Toys "R" Us*, 126 F.T.C. at 567-607. *Amicus* Scherer was the economic witness for the FTC staff.

[10] *Toys "R" Us v. Federal Trade Commission*, 221 F.3d 928, 938 (2000).

> Furthermore, we note that the Commission made a plausible argument for the proposition that there was little or no opportunity to "free" ride on anything here in any event. The consumer is not taking a free ride if the cost of the service can be captured in the price of the item. . . . [T]he manufacturers were paying for the services TRU furnished, such as advertising, full-line product stocking, and extensive inventories.

What this example shows is that arguments supporting RPM and other vertical restraints on free-riding grounds should not be accepted without the most careful analytic and factual scrutiny.

C. The Two Economics of RPM and Other Vertical Restraints

More than fifteen year ago, *amicus* Comanor observed that there are two separate bodies of economic literature dealing with vertical restraints, with distinct welfare and policy implications.[11] Both are relevant for determining appropriate antitrust standards.

In the first, restraints are imposed unilaterally by the seller, normally a manufacturer, to achieve increased sales; while in the second, they are instigated by buyers, normally distributors of the manufacturer's products, in order to protect their high prices. Strikingly, **the efficiency defenses of RPM and other similar restraints arise preponderantly from circumstances where the manufacturer is the moving**

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[11] Comanor, *The Two Economics of Vertical Restraints*, *supra*, n. 6.

party. To the knowledge of the *amici*, there are no arguments in economic analysis supporting restraints arising from distributor actions or pressures. In such circumstances, RPM and similar restraints lead to higher consumer prices with nc demonstrated redeeming values, unless one subscribes to the notion that protecting small retailers is desirable in its own right.

In the past, retailers initiated RPM by threatening to boycott manufacturers' goods unless RPM is imposed, or by bringing other kinds of pressures to bear on local and state governments. An important historical example is that of the retail pharmacists. Their trade association lobbied extensively for state RPM laws and offered draft statutes that were often enacted with little or no amendment by state legislatures.[12] Retail pharmacies were among the last bastions of widespread "fair trading" when the Miller-Tydings Act was repealed in 1975. From the late 1960s to 2003, retail pharmacy margins fell from an average of 40 percent to approximately 20 percent — a saving to consumers and health care insurers of some $40 billion at 2003 sales volumes.[13]

D. Designing Appropriate Standards

The source of the restraint is thus a significant consideration in determining appropriate antitrust standards. For this reason, a "quick look" approach is appropriate.

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[12] F.M. Scherer, *How U.S. Antitrust Can Go Astray: The Brand Name Prescription Drug Litigation*, 4 Int'l J. Econ. Bus. 239, 244-6 (1997).

[13] F.M. Scherer, *Comment on Cooper et al.'s "Vertical Restrictions and Antitrust Policy,"* 1 Comp. Pol'y Int'l 65-74 (2005).

Evidence from a quick look that the restraint was induced by distributors should lead to the presumption of a *per se* violation, rebuttable on the presentation of credible contradictory evidence. On the other hand, preliminary evidence that the restraint was instigated by the manufacturer should trigger a *rule of reason* adjudication.

Where a *rule of reason* approach is appropriate, a test of quantitative substantiality should be applied. The reason is that RPM is most likely to be harmful to consumers when widely applied in a meaningful product line. In such circumstances, consumer choice is restricted to goods bearing high distribution margins in the absence of possible lengthy and energy-guzzling shopping trips. And if under the umbrella of high margins, most retailers engage in substantial pre-sale promotion, their efforts will largely cancel each other out in the aggregate, leading to a high-price, high-margin, high promotional cost equilibrium with relatively little if any expansion of demand.

A rule that takes these considerations into account and strikes a desirable balance between judicial economy and maintaining competition would entail a rebuttable presumption of illegality when the volume of fair-traded sales in a relevant narrowly-defined line of commerce exceeds, say, 50 percent. If this structural criterion is satisfied, antitrust standing would be granted if RPM is *extended* to cover an additional 10 percent of the relevant sales — an increment consistent with the 100 point Herfindahl-Hirschman index change under which anti-merger actions are triggered under the joint Department of Justice - Federal Trade Commission Merger Guidelines.

This structural test would be only the first stage in a RPM *rule of reason* proceeding. Respondents could then rebut the presumption of illegality by proving that the relevant market is improperly defined, that consumers' choices have not in fact been significantly limited, and/or that the restraints were necessary to sustain the provision of services valuable to consumers.

Alternatively, the triggering rule could conform even more closely to the approach taken in the Merger Guidelines. The first structural test would inquire whether the relevant line of commerce is oligopolistic, *e.g.*, with a Herfindahl-Hirschman index exceeding 1800. Focusing on oligopolistic sellers' market structure is appropriate because under oligopoly, imitation of one leading seller's marketing strategy by other sellers is more likely than with atomistic market structures. Antitrust action could then be triggered when RPM is implemented by a seller with a relevant market share of 10 percent or more, *i.e.*, with a Herfindahl-Hirschman change of 100 or more. Again, the presumption of illegality could be rebutted under a *rule of reason* defense.

CONCLUSION

The issue before the Court is an important one for American consumers. The wrong set of rules could encourage proliferation of RPM contracts, impose substantial losses on consumers, and impair the impressive efficiency of the distribution sector in the United States. Marketing innovation should not be discouraged by the imposition of RPM-type restraints. *Amici* believe that some approximation to the approach suggested here would achieve an appropriate tradeoff between consumer benefit, limited government intervention in the marketplace, and adjudicative feasibility.

Respectfully submitted,

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